IFRS 17 *Insurance Contracts*– Sharing of risks
Issues Paper

Objective

1 The objective of this paper is to collect EFRAG TEG members' questions to EFRAG IAWG about sharing of risks practices.

Background

2 Some EFRAG IAWG members are of the view that the business practice of sharing of risk (colloquially referred to as "mutualisation") should overrule the level of aggregation requirements of IFRS 17.

3 At a future meeting EFRAG TEG members will be asked whether they agree with this view in preparing Appendix II of the endorsement advice of IFRS 17.

4 At this meeting, EFRAG TEG members are asked which information they need in order to answer that question. Information requests from EFRAG TEG will be submitted to EFRAG IAWG at their next meeting.

5 For information purposes, Appendix 1 of this paper reflects the draft summary of the responses to the EFRAG IAWG Questionnaire on current accounting practices in relation to sharing of risk. Where possible based on the answers received, a differentiation is made between contract types and by national GAAP.

6 Appendix 2 of this paper reflects the relevant paragraphs of the Basis for Conclusions in IFRS 17 in relation to sharing of risk and interaction with the aggregation requirements of IFRS 17.

Question for EFRAG TEG

7 What information do EFRAG TEG members want to obtain from EFRAG IAWG members in order to assess whether or not sharing of risk practices should overrule the level of aggregation requirements of IFRS 17?

Appendix 1: EFRAG IAWG Questionnaire on current accounting practices

Introduction

1 The following paragraphs reflect the draft summary of answers received to the EFRAG IAWG Questionnaire relating to sharing of risks. Where possible based on the answers received, a differentiation is made between contract types and by national GAAP.

How are insurance contracts managed?

Which products fully share risks with other products?

Question 14(A) – Do certain products fully share risks with other products? If so, please explain.

Analysis per product

2 For life and health contracts, two respondents noted that their products fully share the investment risk, one of these respondents being a mutual entity. Six respondents noted their products do not fully share risks with other products.

3 For with-profit contracts, two respondents noted these products fully share risks with other (with-profit) products. Five respondents noted their products do not fully share risks with other products.

4 For other product categories, respondents noted either that risks were not fully shared or that the question was not applicable to them.

Analysis per GAAP

French GAAP

5 For life and health contracts, two respondents noted that the financial risk is fully shared between products. Where separate funds are being used "fonds cantonnés", the analysis was still ongoing, similar as for the technical [insurance] risk. One respondent extended the analysis for life and health contracts to all other product categories.

6 One respondent noted that for life products, the technical and financial risk is shared contractually or legally at a portfolio level.

7 For non-life contracts, one respondent noted that risk sharing does not exist on the French market.

8 For unit-linked contracts, one respondent noted that the whole financial risk is borne by the policyholder.

German GAAP

9 For life and health contracts, one respondent's first assessment was that the risks are almost fully shared between products. Another respondent noted that, although risk sharing being a common principle, there is no risk sharing between individual contracts or between life/health contracts and for example car insurance contracts.

10 One respondent extended the analysis for life and health contracts to all other product categories.

11 For non-life contracts, one respondent referred to risk sharing as a common principle, but pointed also to another form of risk sharing between policyholder and insurance company as being a deductible, which was commonly used as a contractual feature.

12 For investment contracts, one respondent noted the risk was solely on the policyholders' side.

13 For the majority of unit-linked contracts, one respondent noted the risk was solely on the policyholders' side.

UK GAAP

14 For with-profit contracts, two respondents noted these products fully share risks with other (with-profit) products.

US GAAP

15 Closed Block products were noted by one respondent to fully share risks with other products. The respondent extended the analysis for Closed Block products to all other product categories.

Unspecified GAAP

16 One respondent mentioned contracts where policyholders share the same pool of underlying items and form the first layer of risk absorption. Such contracts were available in Continental Europe such as in Austria, France, Germany and Switzerland. Risk sharing was determined either by contract or law.

How does risk-sharing work?

UK GAAP

17 For with-profit products, payout values are set by reference to asset shares. The asset share of a policy is the fair value of the assets backing the policy, and is calculated by accumulating the premiums paid (less allowance for expenses and/or charges) at the actual rates of investment return earned on the underlying assets over the lifetime of the policy (allowing for the effect of tax on the investment returns and of tax relief on expenses for life business), making appropriate allowance for miscellaneous profits and losses.

18 Aggregate profits, or losses, on discontinuance of with-profits policies are calculated each year for certain product groups and credited to surviving policies in the calculation of asset shares for that product group. This aggregate profit or loss is the difference, in respect of discontinuing policies, between the asset share allowing for the expenses incurred in running the business and the asset share allowing for the charges taken to cover these expenses. These expenses include the actual cost of shareholder transfers. Aggregate profits, or losses, that may emerge from any other UK business risk will be credited each year to asset shares across all UK product lines (excluding one specific product range).

19 Divisible profit arising in the with-profits fund, including profit that arises on the non-profit business, is divided between with-profits policyholders and shareholders. The proportion of divisible profit attributable to with-profits policyholders is defined by the Articles of Association as being at least 90%, with the balance attributable to shareholders. For virtually all business, the policyholders' proportion is currently 90%.

US GAAP

20 Closed Block products: Assets, liabilities and earnings of the Closed Block are specifically identified to support its participating policyholders. Assets allocated to the Closed Block insure solely to the benefit of the Closed Block policyholders and will not revert to the benefit of the shareholders. No reallocation, transfer, borrowing or lending of assets can be made between the Closed Block and other portions of the insurer's general account, without the approval of the authorities. Closed Block assets and liabilities are carried on the same basis as similar assets and liabilities held in the General Account.

21 The excess of Closed Block liabilities over Closed Block assets (adjusted to exclude the impact of related amounts in AOCI) represents the expected maximum future post-tax earnings from the Closed Block that would be recognized in income from continuing operations over the period the policies and contracts in the Closed Block remain in force.

22 An actuarial calculation of the expected timing of the Closed Block's earnings is made. If the actual cumulative earnings from the Closed Block are greater than the expected cumulative earnings, only the expected earnings will be recognized in net income. Actual cumulative earnings in excess of expected cumulative earnings at any point in time are recorded as a policyholder dividend obligation because they will ultimately be paid to Closed Block policyholders as an additional policyholder dividend unless offset by future performance that is less favorable than originally expected. If a policyholder dividend obligation has been previously established and the actual Closed Block earnings in a subsequent period are less than the expected earnings for that period, the policyholder dividend obligation would be reduced (but not below zero). If, over the period the policies and contracts in the Closed Block remain in force, the actual cumulative earnings of the Closed Block are less than the expected cumulative earnings, only actual earnings would be recognized in income from continuing operations. If the Closed Block has insufficient funds to make guaranteed policy benefit payments, such payments will be made from assets outside the Closed Block.

23 Many expenses related to Closed Block operations, including amortisation of deferred policy acquisition costs ("DAC"), are charged to operations outside of the Closed Block; accordingly, net revenues of the Closed Block do not represent the actual profitability of the Closed Block operations. Operating costs and expenses outside of the Closed Block are, therefore, disproportionate to the business outside of the Closed Block.

What is the relative share of those products?

Question 14(B) – What is the relative share of the products that fully share risks compared to the total amount of insurance liabilities accounted for according to European and US GAAP?

24 One respondent indicated that the with-profits business represents 36% of total business accounted for under European GAAP and 59% of its total non-European and non-US business liabilities. Two respondents answered 0% for all categories.

25 Other respondents left this question blank or are still reviewing their answer.

How is risk-sharing determined?

Question 14(C) – How is the risk sharing determined – contractually or on some other basis? If not contractually determined, please explain how it is determined.

Belgian GAAP

26 For <u>life and health contracts</u>, <u>non-life contracts</u> and <u>investment contracts</u>, one respondent noted that risk-sharing was not contractually determined as it was already incorporated in the local insurance law.

UK GAAP

27 For <u>all contract types</u>, one respondent referred to a regulatory document which sets out discretion in the investment management and bonus declaration.

Which products partially share risks with other products?

Question 15(A) – Do certain products <u>partially</u> share risks with other products? If so, please explain.

Analysis per GAAP

French GAAP

28 For life and health products, one respondent noted that risk was partially shared where there was a direct policyholder's participation to the returns generated by a pool of assets or to the total net income (including expenses and other components) generated by the insurance company.

29 For non-life contracts, one respondent noted no risk sharing occurred for these products in this jurisdiction.

30 For unit-linked contracts, one respondent noted that 100% of the financial result was shared between policyholders, except where these contracts provide a minimum guaranteed interest rate.

German GAAP

31 For life and health products, one respondent noted that risk was partially shared where there was a direct policyholder's participation to the returns generated by a pool of assets or to the total net income (including expenses and other components) generated by the insurance company.

32 For non-life contracts, one respondent noted that only for a particular contract (accident insurance combined with an endowment insurance) there existed a form of risk-sharing. Not for other products in this jurisdiction.

33 For unit-linked contracts, one respondent noted that 100% of the financial result was shared between policyholders, except where these contracts provide a minimum guaranteed interest rate.

Italian GAAP

34 For life and health products, one respondent noted that risk was partially shared where there was a direct policyholder's participation to the returns generated by a pool of assets or to the total net income (including expenses and other components) generated by the insurance company.

35 For non-life contracts, one respondent noted no risk sharing occurred for these products in this jurisdiction.

36 For unit-linked contracts, one respondent noted that 100% of the financial result was shared between policyholders, except where these contracts provide a minimum guaranteed interest rate.

37 All other respondents indicated that this is not relevant or referred to/repeated their answer under Question 14(A).

What is the relative share of those products?

Question 15(B) – What is the relative share of the products that partially share risks compared to the total amount of insurance liabilities accounted for according to European and US GAAP?

38 For life and health contracts, one respondent noted these products represent a majority of the insurance liabilities, three other respondents indicated ranges between 75% and 100% of their portfolio.

39 For with-profit contracts, one respondent indicated these represent 36% of their insurance/participating investment business using European GAAP.

40 For all product categories, one respondent noted not to have material products that share risks with other products.

41 For with-profit contracts, one respondent noted these contracts represent 36% of their business under local GAAP.

42 One respondent indicated that with-profits account for 36% of their insurance/participating investment business using European GAAP.

43 All other respondents indicated that this is not relevant or referred to/repeated their answer under Question 14(A).

What is the relative share of products that contractually share risks?

Question 15(C) – What is the relative share of products that contractually share risks compared to the total amount of insurance liabilities accounted for according to European and US GAAP?

44 For life contracts, non-life contracts, investment contracts, unit-linked contracts and reinsurance contracts, two respondents noted these products do not contractually share risks.

45 One respondent referred to their answer under Question 14(C) whereas others indicated that this is not applicable.

Disclosures about risk-sharing

Question 16 – In both cases of risk sharing described in the previous questions, do you provide qualitative and/or quantitative disclosures about the sharing of risks between product types in your financial statements?

46 For life and health contracts, four respondents noted to provide (high-level) qualitative disclosure about risk sharing. One of these respondents only referred to the principle of mutualisation being applied between investment components and insurance guarantees. The other respondents did not provide disclosures or replied the question was not applicable to them.

47 For with-profit contracts, one respondent noted to provide qualitative and quantitative information about how the surplus for distribution is allocated between policyholders and shareholders.

48 Five respondents noted not to provide disclosures on risk sharing. Others indicated this question was not applicable to them.

Appendix 2: Extracts from IFRS 17 Basis for Conclusions on the sharing of risks

Cash flows that affect or are affected by cash flows to policyholders of other contracts (paragraphs B67–B71 in IFRS 17)

BC171 Sometimes insurance contracts in one group affect the cash flows to policyholders of contracts in a different group. This effect is sometimes called 'mutualisation'. However, that term is used in practice to refer to a variety of effects, ranging from the effects of specific contractual terms to general risk diversification. Consequently, the Board decided not to use the term but instead to include in IFRS 17 requirements that ensure the fulfilment cash flows of any group are determined in a way that does not distort the contractual service margin, taking into account the extent to which the cash flows of different groups affect each other. Hence the fulfilment cash flows for a group:

(a) include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders; and

(b) exclude payments to policyholders in the group that, applying (a), have been included in the fulfilment cash flows of another group.

BC172 The reference to future policyholders is necessary because sometimes the terms of an existing contract are such that the entity is obliged to pay to policyholders amounts based on underlying items, but with discretion over the timing of the payments. That means that some of the amounts based on underlying items may be paid to policyholders of contracts that will be issued in the future that share in the returns on the same underlying items, rather than to existing policyholders. From the entity's perspective, the terms of the existing contract require it to pay the amounts, even though it does not yet know when or to whom it will make the payments.

BC173 The Board considered whether it was necessary to amend the requirements in IFRS 17 relating to the determination of the contractual service margin for insurance contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. The Board concluded that it was not necessary because the fulfilment cash flows allocated to a group described in paragraph BC171 result in the contractual service margin of a group appropriately reflecting the future profit expected to be earned from the contracts in the group, including any expected effect on that future profit caused by other contracts.

BC174 The Board also considered whether it was necessary to amend the requirements in IFRS 17 restricting contracts in a group to those issued more than one year apart, but concluded that it was not necessary (see paragraph BC138).

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BC138 The Board considered whether prohibiting groups from including contracts issued more than one year apart would create an artificial divide for contracts with cash flows that affect or are affected by cash flows to policyholders of contracts in another group. Some stakeholders asserted that such a division would distort the reported result of those contracts and would be operationally burdensome. However, the Board concluded that applying the requirements of IFRS 17 to determine the fulfilment cash flows for groups of such contracts provides an appropriate depiction of the results of such contracts (see paragraphs BC171–BC174). The Board acknowledged that, for contracts that fully share risks, the groups together will give *the same results as a single combined risk-sharing portfolio, and therefore considered whether IFRS 17 should give an exception to the requirement to restrict groups to include only contracts issued within one year. However, the Board concluded that setting the boundary for such an exception would add complexity to IFRS 17 and create the risk that the boundary would not be robust or appropriate in all circumstances. Hence, IFRS 17 does not include such an exception. Nonetheless, the Board noted that the requirements specify the amounts to be reported, not the methodology to be used to arrive at those amounts. Therefore it may not be necessary for an entity to restrict groups in this way to achieve the same accounting outcome in some circumstances.*

BC139 Once an entity has established a group of insurance contracts, it becomes the unit of account to which the entity applies the requirements of IFRS 17. However, as noted above, an entity will typically enter into transactions for individual contracts. IFRS 17 therefore includes requirements that specify how to recognise groups that include contracts issued in more than one reporting period, and how to derecognise contracts from within a group.